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PP RUEHGR
DE RUEHKG #0614/01 2301901
ZNR UUUUU ZZH
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FM AMEMBASSY KINGSTON
TO RUEHC/SECSTATE WASHDC PRIORITY 7946
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
INFO RUCNCOM/EC CARICOM COLLECTIVE
RUEHOT/AMEMBASSY OTTAWA 2410
RUEHLO/AMEMBASSY LONDON 0601

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SENSITIVE
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STATE FOR WHA/CAR (JMACK-WILSON)(VDEPIRRO)(WSMITH)
WHA/EPSC (MROONEY) (FCORNEILLE) (AWONG)
EEB/IFD/OMA
WHA/PPC (JGONZALEZ)
INR/RES (RWARNER)
INR/I (SMCCORMICK)
SANTO DOMINGO FOR FCS AND FAS
TREASURY FOR ERIN NEPHEW
EXPORT IMPORT BANK FOR ANNETTE MARESH

E.O. 12958: N/A
TAGS: ECON ENRG EFIN EINV ETRD PGOV PREL IADB IBRD IMF
TRYS, JM, XL
SUBJECT: JAMAICA: MONETARY GAINS, FISCAL PAIN, AND DOWNGRADES

REF: A. KINGSTON 581
¶B. KINGSTON 551
¶C. KINGSTON 601
¶D. KINGSTON 245
¶E. KINGSTON 422

¶1. (SBU) SUMMARY: After a series of austere monetary measures, led by record high interest rates, the foreign exchange market has been showing signs of stability, reflected in the marginal depreciation of the Jamaican dollar during the June quarter. The stock of Net International Reserves (NIR) also has stabilized at USD 1.6 billion as demand pressures for foreign currency appear subdued and inflation moderates to four percent for the first half of 2009. These gains come at a significant cost to the fiscal accounts. The fiscal deficit was USD 403 million, USD 46 million more than budgeted, because of falling revenue collection. Government of Jamaica (GOJ) spending had to be slashed by USD 87 million. This fiscal situation triggered a second downgrade in Jamaica's credit rating to CCC+ by Standard and Poor's on August 5, drawing the ire of the GOJ. The economy has not been in such dire straits since the economic stagnation referred to as the "lost decade" of the 1970s. End summary.

Central Bank Updates Nation

¶2. (SBU) On August 12, Bank of Jamaica (BOJ-Central bank) Governor Derick Latibeaudiere hosted a press briefing, attended by Emboffs, to update the country on recent financial and economic developments. He noted the concern many Jamaicans felt about returning to the International Monetary Fund (IMF), but said it was necessary to address structural reforms in a sustainable manner (Reftels A and B). He assured the press that the BOJ continues to keep monetary policy focused on maintaining macro-economic stability. He stated that most economic indicators were pointing in the right direction, with inflation moderating, the exchange rate stable, and the current account deficit improving.

¶3. (SBU) Inflation for the June quarter was 2.7 percent, well below the GOJ's target of 5.5 percent. Inflation for the first half of 2009 was four percent, well below the 11.5 percent recorded during the similar period of 2008. Latibeaudiere attributed the moderation to the bank's tight monetary policy stance.

BOJ Defends Policy Actions

¶4. (SBU) The BOJ has come under significant public criticism, particularly from the business community, for its high interest rate policy (Reftel C). Latibeaudiere defended his policy actions saying, "Whatever interest rate path the bank pursued was absolutely correct." When one journalist at the briefing remarked that the country now had to "suffer under the impact of overly aggressive measures" by Latibeaudiere, he responded, "you mean we are now reaping the benefits of my actions."

¶5. (SBU) Latibeaudiere noted that the IMF commended the bank for its monetary policy stance, saying it was a miracle the BOJ was able to maintain stability amidst the resource constraints. He argued that making policy decisions in an extraordinarily difficult environment involved tough choices. He told the audience that he was committed to never taking actions that could compromise sound monetary policy or actions that might undermine the bank's mandate of price and financial stability.

¶6. (SBU) He noted that the bank's policy actions had yielded some positive results, noting that the Jamaican currency had depreciated by only 0.3 percent during the June quarter. Although this might appear impressive, given that the currency had lost 22 percent of its value between September and February, it came against the background of a 24 percent hike in interest rates. This was augmented by frequent injections from the Net International Reserves (NIR) to augment supplies. These measures resulted in a contraction in the need for foreign currency to purchase imported goods. This in turn, led to a marked improvement in the current account deficit, which is projected to move from 21 percent of GDP in 2008/09 to 12 percent of GDP in 2009/10, despite the fall out in bauxite, tourism, and remittances (Reftel D). At the end of June, the stock of NIR

had stabilized at USD 1.6 billion or about 13 weeks of goods and services imports-- up from USD 1.5 billion a few months ago, but still well down from 2.2 billion when the global recession began.

Stablization Gains Cause Fiscal Pain

¶7. (SBU) The BOJ's measures have not been without cost to the fiscal accounts; the high interest rate policy has increased debt serving costs in the June quarter by USD 25 million. For the June quarter, central government operations also generated a deficit of USD 403 million; USD 46 million more than budgeted. The continued deterioration was due to declining revenue collection, as spending was slashed by USD 87 million to bring expenditure closer in line with falling revenues. The BOJ's demand management program (depreciation and interest rate hike) has reduced consumption and thus reduced import taxes. The GOJ is not able to cut all spending, notably obligatory expenditures (interest payments and wages), and thus its goal of a fiscal deficit of 5.5 percent of GDP has been shattered.

Economic Contraction, Fears of Another Lost Decade

¶8. (SBU) The BOJ's measures have also impacted the already moribund Jamaican economy, which is estimated to have declined by a further 3.5 to 4.5 percent during the June quarter. This was the sixth consecutive quarter of decline and is the sharpest contraction in ten years. The fall off continues to be led by the Mining and Quarrying sector, as lost output from the closure of three of the country's four bauxite plants continue to take its toll (reftel D). The stagnation in the construction industry also impacted output growth. The contraction in GDP continues against the background of weak external and domestic demand from the lingering global economic downturn. Jamaica is facing its worst economic situation since the 1970s--referred to as a "lost decade" of growth marked by economic setbacks and job losses.

Hard Decisions Must Be Taken

¶9. (SBU) Deteriorating economic conditions, led by the weakening fiscal dynamics, have forced an abandonment of the medium term economic framework. Prime Minister (PM) Bruce Golding has already announced the tabling of a revised budget (Supplementary Estimate) when Parliament resumes in September. This revised budget could increase the deficit to over seven percent of GDP, unless the GOJ is successful in negotiating an interest rate concession this year (Reftel E). The economic contraction is expected intensify, meaing the projected three to four pecent contraction of GDP could rise to five or six percent. On a brighter note, the 2009 inflation target has been reduced to between 11 and 12 percent, while interest rates have begun to decline, albeit slowly.

To Consider Terms For IMF Return

¶10. (SBU) PM Golding also announced that his Cabinet had considered the terms on which his government will return to the IMF when it met on August 17. He said once the terms are decided by Cabinet it will be open for public discussion, and constructive concerns will be taken on board. However, Golding was quick to point out that some of the terms of the agreement will not be pleasant. "When you are sick, you have to take medicine", said Golding. The country could be in for some immediate relief, as the BOJ is set to pick up USD 328 million in Special Drawing Rights (SDR) from the IMF in September. This should strengthen the bank's stock of NIR, thus furthering stability in the foreign exchange market.

Standard and Poor's Delivers Body Blow

¶11. (SBU) As Jamaica contemplates a return to the IMF, ratings agency Standard and Poor's has announced a downgrade of the country's credit ratings from B- to CCC+. This second downgrade in less than a year was based on what S and P considers Jamaica's vulnerable fiscal profile, combined with difficult financing

conditions, amidst a weak debt profile. The ratings agency said this could well compel the GOJ to undertake a debt exchange that could be regarded as a distressed debt exchange (default). With 25 percent of debt maturing within a year and with 50 percent of the debt foreign-exchange indexed, S and P suggests that debt servicing costs will rise to 60 percent of the budget in 2009, up from 48 percent in 2008. The agency also is forecasting that debt-to-GDP will jump to 120 percent by the end of 2009.

GOJ Hits Back - Dispels Default Rumor

¶12. (SBU) Responding to the downgrade, Audley Shaw, Minister of Finance and the Public Service(MFPS), stated that the ratings agency ignored the positive economic developments led by foreign exchange market stability and declining interest rates. He also emphasized that the GOJ does not intend to pursue any transaction with its creditors that could be viewed as a distressed transaction. Latibeaudiere called the downgrade "pre-mature" and in echoing Shaw's comments said the GOJ "continues to maintain its resolve to honor all obligations, as contracted, and therefore the rating action was unwarranted." PM Golding also maintained that there was absolutely no chance of Jamaica defaulting on its debt, as Jamaica was one of the few countries where the prior claim on budgetary expenditure of debt repayment were guaranteed by a provision in the Constitution.

COMMENT

¶13. (SBU) The S and P downgrade has dealt a major psychological blow to the already beleaguered Jamaican Labor Party (JLP)-led administration, but it might not have any material impact in the short-term, given that Jamaica has been frozen out of the private capital market. In fact, it is the investors who already hold Jamaican bonds who will most likely be affected, which could explain the outrage coming from this sector. Even if the ratings action was premature, as a starting point, the GOJ must acknowledge the

fundamentals of the S and P findings--that the country has a vulnerable and precarious fiscal situation. Consequently, the downgrade, coupled with the imminent return to the IMF, should be viewed as another perfect opportunity for the PM Golding and his party to finally address the structural impediments to growth and development. Although this move will be riddled with political risks due to difficult choices, any further postponement of the pain, in order to maintain political capital, could well result in another lost decade. END COMMENT.
MOSS